

Recent Decisions Affecting Insolvency and Commercial Finance in California

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I. Introduction and Caveats.

In this article, I summarize a variety of 2004 decisions affecting insolvency and commercial finance rendered by courts within the Ninth Circuit, both state and federal. Because of space constraints, this isn't an exhaustive summary, and my comments have been significantly abbreviated; if you'd like a considerably more detailed treatment of these issues, please feel free to see the full text of my analysis on the Westlaw Commercial Finance Newsletter database. Also, please be forewarned that this article contains my clearly-labeled editorial comments, in addition to just straight reporting. Those comments are my idiosyncratic opinions and should not be imputed to the Insolvency Law Committee or to Westlaw.

II. Fraudulent Transfers.

- The Ninth Circuit held that when a corporation receives loan proceeds in exchange for collateralizing its shareholders' debt, the lender holding the collateral has not received a fraudulent transfer because the corporation suffered no net loss. [In re Northern Merchandise, Inc., 371 F.3d 1056 (9th Cir. 2004).]

COMMENT: The facts in this case are of the "man bites dog" variety; in most "upstream" transactions involving insolvent corporations, there is evidence of corporate looting, such as profits received by the shareholders and interest payments being made on their behalf by the subsidiary. Here, however, the shareholders appear to have done everything right: they transferred all of the value to the corporation and retained none of it.

This case is consistent with the trend toward "collapsed transaction" analysis: instead of breaking down each transaction into its component parts, the court looks at the

commercial reality of the transaction to see whether the debtor and its creditors were harmed.

- The Ninth Circuit, distinguishing an earlier United States Supreme Court opinion, held that a fraudulent transfer plaintiff may seek and obtain prejudgment injunctive relief. [*In re Focus Media, Inc.*, 2004 Westlaw 2590496 (9th Cir.).] The court acknowledged that the Supreme Court in *Grupo Mexicano de Desarrollo, S.A., vs. Alliance Bond Fund, Inc.*, 527 U.S. 308, 119 S.Ct. 1961, 144 L.Ed.2d 319 (1999), had held that preliminary injunctions may not be issued to preserve assets to which a party did not yet have a legal claim. However, the Ninth Circuit held that the Supreme Court expressly excepted fraudulent transfer actions from its holding, quoting the following language from *Grupo Mexicano*: "'The law of fraudulent conveyances and bankruptcy was developed to prevent such conduct,' i.e., debtors trying to avoid paying their debts"

The Ninth Circuit also held that the Supreme Court's opinion suggested that when equitable claims were in issue, as opposed to legal claims for damages, the rule prohibiting the issuance of a preliminary injunction freezing the debtor's assets is inapplicable. The Ninth Circuit stated its holding as follows: "[W]e hold that where, as here, a party in an adversary bankruptcy proceeding alleges fraudulent conveyance or other equitable causes of action, *Grupo Mexicano* does not bar the issuance of a preliminary injunction freezing assets."

COMMENT: I think that the appellate court is misreading the Supreme Court's opinion. First, the opinion in *Grupo Mexicano* seems to say that prejudgment injunctive remedies are not available in equity. Second, the Supreme Court did not say that fraudulent transfer plaintiffs are routinely entitled to prejudgment injunctive relief; in fact, the language quoted by the Ninth Circuit was an incomplete quotation, taken out of context. My narrow reading of *Grupo Mexicano* is supported by footnote 7 of that opinion, which says that a plaintiff in a fraudulent transfer action asserting a state law claim arising under the Uniform Fraudulent Transfer Act might have a statutory right to prejudgment injunctive relief. The negative implication is that a plaintiff asserting a fraudulent transfer action under 11 U.S.C. §548 would not have such a right.

- The California Supreme Court held that a plaintiff in a fraudulent transfer case may record a lis pendens against real property transferred by the debtor. [*Kirkeby vs. Superior Court*, 33 Cal.4th 642, 93 P.3d 395, 15 Cal.Rptr.3d 805 (2004).] The court reasoned that the relief requested in the fraudulent conveyance action sought avoidance of the transfers of the real property; thus, the action involved a "real property claim" within the meaning of the lis pendens statutes.

COMMENT: This case is counter to the trend, which has been to restrict the rights of creditors invoking the lis pendens statutes. It is very unfortunate that the language of the statute is not more precise; the Legislature itself acknowledged that imprecision in Comment 5 to C.C.P. §405.4.

The holding in this case gives rise to some odd results. First, imagine a situation in which the defendant defrauds the plaintiff, uses the money to buy real property, and then fraudulently transfers the real property. If the plaintiff files a fraudulent transfer action and seeks to avoid the transfer, then the plaintiff should be able to record a lis pendens because the fraudulent transfer action "affects title."

By contrast, imagine a situation in which the defendant defrauds the plaintiff, uses the money to buy real property, but does not transfer it. The plaintiff cannot file a fraudulent transfer action but must instead file a tort claim and assert the existence of an equitable lien, at best. Under the currently-prevailing line of cases, the plaintiff is simply an unsecured tort creditor, with no attachment remedy and no opportunity to assert a lis pendens. Yet ironically, under Kirkeby, the further-removed the property is from the victim of the fraud, the more likely it is that the victim can assert a lis pendens. Given the continuing uncertainty over the scope of the statute, perhaps the Legislature will accept the Supreme Court's invitation to clarify the statute.

- A California appellate court has held that a plaintiff asserting a fraudulent transfer claim under the Uniform Fraudulent Transfer Act ("UFTA") is entitled to a jury trial. [Wisden vs. Superior Court, 124 Cal.App.4th 750, 21 Cal.Rptr.3d 523 (2004).] The court cited Granfinanciera, SA vs. Nordberg, 492 U.S. 33, 109 S.Ct. 2782 (1989), holding that under traditional English common law, an action to recover a fraudulent conveyance of a specific sum of money would have been a legal action tried to a jury.

COMMENT: There are very few state court decisions precisely on point, but (in the wake of Granfinanciera) this decision is not particularly surprising. However, I don't think that this decision means that every fraudulent transfer action brought under the UFTA must be tried to a jury: if the plaintiff wants to avoid a jury trial, perhaps the plaintiff could frame the complaint so as to seek the return of specific property, rather than a specific sum of money.

III. Preferences.

- The Ninth Circuit held that when a creditor receives a replacement check for a previously-issued (but later dishonored) check, the creditor can no longer assert the "contemporaneous exchange" defense to a preference claim brought by a bankruptcy trustee. [In re JWJ Contracting Co., Inc., 371 F.3d 1079 (9th Cir. BAP 2004).] The court reasoned that "a creditor's acceptance of what turns out to be a dishonored check, in exchange for new value given to the debtor, transforms what would have been a contemporaneous exchange . . . into a credit transaction."

COMMENT: The circuits are in general agreement that the issuance of a replacement check creates a "credit transaction;" thus, I doubt we will see a Supreme Court opinion on this point.

IV. Automatic Stay

- Reversing itself, the Ninth Circuit has held that an individual debtor may collect emotional distress damages under §362(h) of the Bankruptcy Code, following a creditor's willful violation of the automatic stay. [In re Dawson, 2004 Westlaw 2827663 390 F.3d 1139 (9th Cir.).]

COMMENT: This case sets up a clear circuit split. It is hard to predict what will happen if this issue makes it up to the Supreme Court, since the statute does not expressly limit the scope of damages to economic harm; thus, a "plain reading" of the statute plausibly includes emotional distress damages. On the other hand, if Congress had meant to include emotional distress damages, perhaps it would have done so expressly.

I wonder whether this newly-articulated rule will preempt comparable state remedies. The court's original opinion strongly implied that there was no such preemption: "State laws . . . provide tort remedies for intentional infliction of severe emotional distress, and §362(h) does not duplicate those tort remedies." But this new opinion does not mention that issue, and the court's new rule does (in some sense) duplicate state law tort remedies. Does that unexplained omission lead to an inference of preemption?

- The Ninth Circuit BAP has held that a bankruptcy court may not deny relief from the automatic stay to a creditor holding an attachment lien who seeks to return to state court to perfect that lien, unless there are independent grounds for denial of relief. [In re Robbins, 310 B.R. 626 (9th Cir. BAP 2004).]

COMMENT: This is one of those situations in which the cracks between the federal and state systems create bizarre Catch-22 dilemmas. The Ninth Circuit itself, in In re Southern California Plastics, Inc., 165 F.3d 1243, 1246 (9th Cir. 1999), noted that the BAP in that case had observed that "forcing the creditor to litigate in state court would undermine the objectives of the automatic stay," a position that the Ninth Circuit characterized as "sensible." Nevertheless, the Ninth Circuit then held that because the validity of the attachment lien was governed by state law, the creditor was forced to go back to state court to perfect the lien.

So now, the procedural chickens have come home to roost; thus, in Robbins, the creditor was forced to obtain relief from the stay and to go back to state court, simply to perfect the attachment lien, thus wasting everyone's time and money. Is there any way to

avoid this train wreck? I think so: the Ninth Circuit's deference to California law means that the California statute could be amended to provide that the allowance of a claim in bankruptcy is the equivalent of a judgment and gives rise to a judgment lien. The Insolvency Law Committee is currently debating whether to propose an amendment to the Code of Civil Procedure to solve this continuing problem.

- A bankruptcy court in California held that when a debtor and its related entities have filed successive bad faith bankruptcy petitions in order to thwart tax sales or foreclosures, the court may impose "in rem" relief from the automatic stay, binding upon all subsequent transferees of the property. [In re Golden State Capital Corp., 317 B.R. 144 (Bankr. E.D. Cal. 2004).]

COMMENT: The court's solution is creative and clever, but it is outside the scope of the Bankruptcy Code as it is currently written. Courts faced with serial "foreclosure fraud" have struggled to develop a remedy for this significant problem for several years; there is still no clear consensus. The bankruptcy bill currently pending before Congress contains a provision expressly authorizing "in rem relief" under appropriate circumstances, but the bill has been pending for several years, and there is no indication that it will pass any time soon.

V. Exemptions.

- The Ninth Circuit BAP has held that a senior judicial lien may be avoided under §522 of the Bankruptcy Code, even though the alleged "impairment" of the debtor's homestead exemption did not arise until the debtor subsequently encumbered the property in favor of a junior consensual lienholder. [In re Charnock, 2004 Westlaw 3050738 (9th Cir. BAP).] The court held that the plain language of the statute was controlling; it provides for the avoidance of judicial liens that impair exemptions, and it does not distinguish between junior and senior liens.

The creditor argued that this harsh result would confer a windfall on the debtor, but the court disagreed: "[E]very creditor who seeks a judgment and thereafter obtains a judicial lien should know that judicial liens may be subject to exemptions. That risk is simply part of the calculus of whether to seek a judgment"

COMMENT: There is just no doubt that §522, if construed literally, means that senior judicial liens are extinguished, even though the impairment of the debtor's exemption only occurs when the debtor subsequently piles on additional consensual junior liens. Congress knew exactly what it was doing.

The most revealing part of this opinion is the court's statement that a creditor "should know that judicial liens may be subject to exemptions." Translation: judicial lien creditors are a low form of life, entitled to little protection. The message to unsecured creditors, unfortunately, is that creditors seeking recovery must pursue collection more aggressively, or must obtain collateral, or must charge even-higher interest rates to compensate for the increased risk of uncollectibility.

VI. Claims.

- The Ninth Circuit BAP has held that absent special circumstances, an assignee of a claim against a bankrupt need not disclose the consideration paid. [In re Burnett, 306 B.R. 313 (9th Cir. BAP 2004).]

COMMENT: If I'm reading F.R.B.P. 3001(e) correctly, the fact that the assignment occurs before or after the filing of the proof of claim should be irrelevant. In either event, the assignee is not required to disclose the consideration paid. I can understand why debtors would want to know how much an assignee paid for a given claim; if the assignee paid very little, the assignee might be willing to settle more cheaply.

- A bankruptcy court in California has held that an assignee of a claim against an individual debtor may be liable for the return of excessive payments, even where the payments were actually received by the assignor. [In re Barker, 306 B.R. 339 (Bankr. E.D. Cal. 2004).]

COMMENT: The court stated that it was publishing its opinion " because the business of selling charged-off bankruptcy accounts is growing and has been little litigated." In other words, this opinion is a shot across the bow for those who buy up claims at a discount. The messages are very clear: first, the assignee must comply with Rule 3001, so that notice is given to the assignee when significant developments occur. Second, the assignee needs to set up clear channels of communication between the assignor and the assignee; this case involved several miscommunications. Third, perhaps the assignor should be required by the assignee to hold any mistaken payments in trust for the assignee. (As a business matter, I'm not sure that the assignor would agree to such a term, but it may be worth requesting.)

VII. Chapter 11.

- The Supreme Court has held that in the context of a Chapter 13 plan, the bankruptcy court correctly chose the "formula approach" for calculating cramdown interest, relegating a subprime lender to a 9.5% rate. [Till vs. SCS Credit Corp., 541 U.S. 465, 124 S.Ct. 1951, 158 L.Ed.2d 787 (2004).] The opinion may have far-reaching implications not only for the subprime market but also for commercial lenders whose borrowers file Chapter 11 petitions.

The court discussed various possible approaches and ultimately selected the "formula rate," which was the one used by the bankruptcy court in this case: "[T]he

approach begins by looking to the national prime rate [T]he approach then requires a bankruptcy court to adjust the prime rate accordingly." [Slip Opinion, 12-13.]

The court declined to decide "the proper scale for the risk adjustment," but the court noted that earlier courts have "generally approved adjustments of 1% to 3%" [Slip Opinion, page 14.] The court stated that bankruptcy courts should "select a rate high enough to compensate the creditor for its risk but not so high as to doom the plan." [Id.] The court noted that the bankruptcy court "must therefore hold a hearing at which the debtor and any creditors may present evidence about the appropriate risk adjustment [S]tarting from a concededly low estimate and adjusting upward places the evidentiary burden squarely on the creditors" [Slip Opinion, page 13.]

COMMENT: This opinion could have drastic implications for all sorts of lending transactions, and not only in the narrow context of "subprime" consumer lending. The language of the statute at issue in this case is essentially the same as that governing "cramdown" plans in Chapter 11. Although the plurality did not expressly hold that the appropriate cramdown rate is "prime plus a little sweetener, not to exceed 3%," that is the clear implication of the plurality's reasoning. Nor does it appear that the bankruptcy courts will have much latitude to depart upward from the 3% ceiling mentioned by the court.

Without doubt, this opinion will have a huge impact on the "subprime" market, since lenders will have to "frontload" this risk by building it into every borrower's interest rates. Lenders might try to insist on more conservative loan-to-value ratios, although that would be difficult in the subprime market, since subprime borrowers (by definition) cannot make large down payments. Assuming that this opinion governs cramdown in Chapter 11, it will have a similar effect on ordinary "nonprime" commercial finance, since the cramdown rate will often be below the contract rate.

There does not appear to be any way of drafting around this decision: regardless of what the contract says, the bankruptcy court is now free to impose its own cramdown interest rate.

- Noting a split of authority, the Ninth Circuit BAP has held that when a debtor seeks to use cash collateral, the debtor need not meet the stricter standard applicable to surcharge proceedings under Bankruptcy Code §506(c). [In re Proalert, LLC, 314 B.R. 436 (9th Cir. BAP 2004).]

COMMENT: Frankly, I was surprised to find that there was a split of authority on this issue. The BAP's position seems to be clearly right. Were the rule otherwise, cash collateral hearings would often deteriorate into long and expensive evidentiary hassles, which would defeat the whole purpose of cash collateral relief in the early days of the reorganization process.

- A bankruptcy court in the Northern District of California has held that a Chapter 11 plan filed by a solvent debtor solely for strategic reasons is in "bad faith" and must be dismissed. [In re Liberate Technologies, 314 B.R. 206 (Bankr. N.D. Cal. 2004).] Citing In re Sylmar Plaza LP, 314 F.3d 1070 (9th Cir. 2002), the court held that the good faith of a Chapter 11 petition must be determined in light of the facts and circumstances. Here, although the debtor faced serious business difficulties, it also had plenty of cash with which to take care of its liabilities.

COMMENT: I predict that the Ninth Circuit will reverse. I think that Sylmar Plaza stands for the proposition that a solvent debtor can nevertheless invoke Chapter 11 for strategic reasons. In Sylmar, a solvent group of equity holders defrauded their secured lender by transferring the collateral to a newly-created limited partnership and then transferring the rest of their assets into other newly-created entities. They then filed their Chapter 11 petition on the day that the state court was about to enter judgment in the secured lender's judicial foreclosure action.

By holding that this egregious behavior did not constitute "bad faith," it seems to me that the Ninth Circuit held in Sylmar that "bad faith" does not mean much on the West Coast. Further, Sylmar expressly held that "insolvency is not a prerequisite to a finding of good faith under §1129(a)." In contrast to the facts in Sylmar Plaza, the behavior of the debtor in Liberate was far less outrageous.

VIII. Breach of Fiduciary Duty

- A bankruptcy court in Arizona has held that a trustee in bankruptcy may assert claims assigned to him by the estate's creditors but that the estate itself cannot assert a breach of fiduciary duty claim against the debtor's parent entity, since the debtor was a wholly-owned subsidiary. [In re Southwest Supermarkets, LLC, 315 B.R. 565 (Bankr. D. Ariz. 2004).] Citing a Delaware case, the court held that "when a subsidiary is wholly owned, its officers and directors owe their fiduciary duties solely to the single shareholder, and not to the subsidiary corporation itself."

COMMENT: I think that this opinion is wrong on two different levels. First, there is little or no authority for the proposition that the trustee may prosecute specific creditors' claims assigned to the trustee for purposes of prosecution.

Second, there is substantial authority for the proposition that a parent entity that loots an insolvent wholly-owned subsidiary is liable to the estate for breach of fiduciary duty. As soon as the subsidiary became insolvent, the parent owed a duty to the subsidiary and its creditors not to harm it in any way, and the trustee has standing to vindicate that harm. See, e.g., In re High Strength Steel, Inc., 269 B.R. 560, 569 (Bankr. Del. 2001), In re Fruehauf Trailer Corp., 250 B.R. 168, 186 (D. Del. 2000), and Pereira v. Cogan, 294 B.R. 449, 519-520 (S.D.N.Y. 2003).

IX. Secured Transactions.

- The Ninth Circuit BAP has held that when a lender holding both real and personal property collateral nonjudicially forecloses on the personal property, that does not violate the "security first" rule under C.C.P. §726 and does not impair the lender's rights in the real estate. [In re Kearns, 314 B.R. 819 (9th Cir. BAP 2004).]

COMMENT: This is clearly the right result, but it illustrates the series of traps that California law has set for the unwary creditor. Even though this particular fact pattern was resolved satisfactorily, there are many unanswered questions regarding the interaction of §726 and the Commercial Code, especially §9604.

- A bankruptcy court in California has held that under former Article 9, a security interest in equipment does not necessarily encompass income received by the debtor as result of leasing the equipment. [In re Rebel Rents, Inc., 307 B.R. 171 (Bankr. C.D. Cal. 2004).]

COMMENT: Reading between the lines (and assuming that the court got the facts right), it appears that there were some serious documentation problems: (1) The financing statement did not track the language of the security agreement. (2) There was no formal assignment of the originating creditor's position to its successor, forcing the successor to rely on equitable subrogation, thus opening the door to equitable defenses. (3) The lienholder failed to get an express security interest in the debtor's leasing income. (4) There was a prejudicial four-month delay in filing a financing statement. (5) The lienholder slept on its rights during the debtor's Chapter 11 case, thus giving rise to an estoppel. (It is sometimes said that studying the law by reading cases is like learning to drive by looking at pictures of really bad accidents.)

- A District Court in the Northern District of California has held that a complex workout agreement involving the transfer of property to a new entity could be viewed as a disguised security device, rather than a legitimate transfer of title. [Family Mortgage Corp. No. 15 vs. Greiner, 2004 Westlaw 2254195 (N.D. Cal.).]

COMMENT: Given the facts and circumstances of this case, I do not see a way of drafting around the problem or restructuring it so as to avoid the problem. As the court itself noted: "If the deed is made for the purpose of securing the payment of the debt, it is a mortgage, 'no matter how strong the language of the deed, or any instrument accompanying it, may be.'"

X. Other Issues Affecting Commercial Finance.

- Noting a conflict of authority, a California appellate court has held that when a real estate broker simply fills out forms in connection with a loan transaction, the broker is not an "arranger," and the loan therefore is not exempt from the California usury laws. [Gibbo vs. Berger, 123 Cal.App.4th 396, 19 Cal.Rptr.3d 829 (2004).]

COMMENT: This is worse than "how many angels can dance on the head of a pin?" This is more like "at what point does a paper-pusher become an arranger?" And the consequences of crossing that very thin line are huge: instead of being a fully-secured creditor, the lender is now an impoverished tortfeasor. ("The loan arranger rides again! . . .")

The blame for this jurisprudential mess should fall on several different heads: First, of course, California's bizarre usury laws are little more than a trap for the unwary, since the "wary" can always take advantage of one of the many exceptions. Second, we can blame the vague and ambiguous language of the "real estate broker/arranger" exception, which was engrafted onto the California Constitution as a result of one of California's many ballot propositions. Third, the lender should have made sure that the "broker/arranger" took a more prominent role in the "arranging" of the transaction; perhaps appropriate self-serving recitals in the documentation might have been helpful.

Now that we have an inter-district conflict, I hope that the California Supreme Court will grant a hearing to clarify the meaning of the word "arrange."

- Noting a conflict of authority, a California appellate court has held that predispute contractual jury waivers are unconstitutional under the California

Constitution, even in commercial cases involving sophisticated parties. [Grafton Partners LP vs. Superior Court, 9 Cal.Rptr.3d 511 (2004).]

COMMENT: The California Supreme Court has granted a hearing in this case, which is no surprise, since (1) we now have two different rules in Northern and Southern California, and (2) this is an issue of great commercial significance. I predict that the Supreme Court will overturn Grafton and will reaffirm the contrary result in Trizec Properties, Inc. v. Superior Court, 229 Cal.App.3d 1616, 280 Cal.Rptr. 885 (1991), upholding the constitutionality of contractual predispute jury waivers because of the commercial importance of those waivers. After Trizec was decided, the Legislature enacted amendments to various parts of C.C.P. §631, and yet it never disavowed the holding in Trizec. That is some indication of legislative ratification of Trizec; yet the Grafton court never even addressed the issue of ratification.

I also predict that the Supreme Court will read §631(d)(2) to authorize predispute contractual waivers that must later be filed with the court. If the Legislature had wanted to say that the waiver had to be executed during the course of the dispute, it would have said so.

- A California court has held that a choice of law clause encompassed both the substantive and procedural statutes of the chosen state because the clause did not distinguish between substance and procedure. [Hughes Electronics Corp. vs. Citibank Delaware, 120 Cal.App.4th 251, 15 Cal.Rptr.3d 244 (2004).]

COMMENT: The drafting lesson is obvious: unless the parties wish to incorporate both substantive and procedural law, the choice of law clause should distinguish between the two. However, in the context of a form contract, it is very unlikely that the more powerful party will negotiate the wording of the clause.

- A California appellate court has held that when a law firm conceals a “toxic stock” provision from an adverse party when the firm prepares reports distributed during a corporate acquisition, the firm may be liable for fraudulent concealment, even though publicly-filed information contained the omitted information. [Vega vs. Jones, Day, Reavis & Pogue, 2004 Westlaw 1719279 (Cal. App.).]

COMMENT: Would it be possible for the firm to have included a provision in the documentation stating that any recipient of the report is deemed to be on notice of any publicly-filed information that contradicts the terms of the report? I doubt whether any disclaimer, no matter how well-drafted, could insulate a firm from liability for intentional misrepresentation. Note that this case extends the reach of an attorney’s duty to adverse

parties, holding the adverse parties have a right to rely on statements made by adverse attorneys.

In turn, that puts a big burden on attorneys in any sort of transactional work: if they prepare factual materials for disclosure to adverse parties, they now must protect themselves by investigating whether the facts provided to them by their clients are true and complete.